Office of Chief Counsel
Internal Revenue Service

memorandum

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MJCalabrese

date: June 12, 2002

to: Daniel Hammer, Senior Team Coordinator
Bert Bennett, Revenue Agent

from: Associate Area Counsel (LMSB), Chicago

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subject: ***Opinion - Capitalization of Investment Department Salaries***

Taxpayer: [redacted]

This responds to your April 26, 2002 request for assistance. We are coordinating this matter with Capitalization Industry Counsel Richard Bloom. This memorandum should not be cited as precedent.

ISSUE

To what extent does Notice 2002-021 affect the taxpayer's treatment of salary costs incurred by its real estate investment office?

CONCLUSION

To the extent it does not constitute a change in accounting method, the taxpayer may currently deduct employee compensation (other than bonuses and commissions), fixed overhead, and de minimis costs (not more than $5,000 per transaction) incurred in the acquisition, creation, or enhancement of an intangible asset or benefit.

FACTS

[redacted] ([redacted]) maintains reserves of many [redacted]. [redacted] invests in various assets. Some funds are devoted to different kinds of [redacted], [redacted], and [redacted] investments. [redacted] sometimes participates in partnerships (either in forming the partnership or in acquiring a partnership interest) that have equity interests in these investments. Sometimes [redacted] serves as a lender to [redacted] or [redacted] of projects.

[redacted] maintains [redacted] investment offices that handle the [redacted], [redacted], and [redacted] investments. As a result of the Service raising the issue in the mid-[redacted]s, [redacted] has been amortizing and capitalizing certain salary costs incurred in acquiring, creating, or enhancing interests in [redacted], [redacted], [redacted] or other capital assets. Some of these capital assets are intangible, such as [redacted] or [redacted].

In an opinion to you dated March 15, 1995, we discussed certain principles regarding the need to capitalize costs incurred in acquiring, creating or enhancing a capital asset. You now ask about the impact of Chief Counsel Notice 2002-21 on the opinion.

ANALYSIS

A taxpayer may deduct an item that is 1) "ordinary", 2) "necessary", 3) an "expense", 4) "paid or incurred during the taxable year", and 5) made for "carrying on any trade or business". I.R.C. § 162(a); Commissioner v. Lincoln Savings and Loan Association, 403 U.S. 345, 354 (1971); Rev. Rul. 99-23, 1999-1 C.B. "The principal function of the term 'ordinary' in § 162(a) is to clarify the distinction, often difficult, between those expenses that are currently deductible and those that are in the nature of capital expenditures... ." Commissioner v. Tellier, 383 U.S. 687, 689 (1966).

A payment is not "ordinary" if it creates a separate and distinct asset or if it "serves to create or enhance" an asset, Commissioner v. Lincoln Savings and Loan Association, 403 U.S. at 353-354, if the payment produces a significant benefit that extends into the subsequent taxable year, INDOPCO, Inc. v. Commissioner, 503 U.S. 79, 87-88 (1992), or if the payment is made "in connection with" the acquisition of a capital asset, Commissioner v. Idaho Power Co., 418 U.S. 1, 13 (1974). See also Lychuk v. Commissioner, 116 T.C. 374, 385-386 (2001); Norwest Corp. v. Commissioner, 112 T.C. 89 (1999); United States v. Wehrli, 400 F.2d 686, 689 (10th Cir. 1968); Central Texas Savings & Loan Ass'n v. United States, 731 F.2d 1181 (5th Cir. 1984). Legal, brokerage, accounting, appraisal, and similar costs incurred to acquire a capital asset are § 263 capital expenditures. Woodward v. Commissioner, 397 U.S. 572 (1970); United States v. Hilton Hotels Corp., 397 U.S. 580 (1970); Rev. Rul. 1973-580, 73-2 C.B. 86.

The asset created, acquired, or enhanced need not be tangible. For example, a payment to acquire goodwill is a capital expenditure. Newspaper Printing Co. v. Commissioner, 56 F.2d 125 (3rd Cir. 1932).

The Supreme Court in INDOPCO, Inc. v. Commissioner, 503 U.S. 79 (1992) rejected the taxpayer's argument that Commissioner v. Lincoln Savings and Loan Association established the principle that capitalization is only required when the expenditure results in the creation or enhancement of a separate and distinct additional asset. The INDOPCO Court concluded that the taxpayer's investment banking, legal and other costs incurred as part of a corporate takeover resulted in long-term benefits. Though intangible, these benefits were not currently deductible under I.R.C. § 162(a).

A taxpayer may not currently deduct I.R.C. § 263(a) capital expenditures. Generally, capital expenditures are amortized and depreciated over the life of the asset. If no specific asset or useful life can be ascertained, the expenditure is generally deductible upon dissolution of the business enterprise. Commissioner v. Tellier, 383 U.S. 687, 689 (1966). The capitalization rules take precedence over the allowance of a deduction in I.R.C. § 162(a). See I.R.C. §§ 161 and 261.

In some recent cases the tax court and certain courts of appeals have not always agreed as to the proper characterization of costs incurred in connection with the acquisition of certain capital assets. In Wells Fargo & Co. v. Commissioner, 224 F.3d 874, (8th Cir. 2000), rev'g on this issue Norwest Corp. v. Commissioner, 112 T.C. 89 (1999), the Service contended that certain salaries constituted a capital expenditure because of the salaries' connection to a corporate acquisition. The court allowed a current deduction for the salaries noting that the salaries were only indirectly related to the acquisition of the capital asset. In PNC Bancorp, Inc. v. Commissioner, 212 F.3d 822, rev'g 110 (3rd Cir. 2000) rev'g 110 T.C. 349 (1998) the circuit court of appeals ruled against the Service in allowing the taxpayer to take a current deduction for salaries and other costs in originating loans, even though the salaries were directly related to the creation of the loans. In Lychuk v. Commissioner, 116 T.C. 374 (2001), the tax court ruled in favor of the Service in requiring the capitalization of certain salaries because the salaries originated in the loan acquisition process. However, the Lychuk court allowed a current deduction for overhead costs because, the court said, the costs did not originate in the loan acquisition process, which thereby made the costs indirectly related to the acquisition.

Recognizing the controversy and uncertainty accompanying the proper characterization and treatment of certain costs relating to the acquisition, creation, or enhancement of an intangible asset or benefit, the Office of Chief Counsel issued Notice 2002-021. The notice announces that as a part of a change in litigation position, the Service will not "assert that certain employee compensation, fixed overhead, or de minimis transaction costs must be capitalized under section 263(a)." The Service expects "to propose a rule that requires capitalization of transaction costs that facilitate an acquisition, creation, or enhancement of certain intangible assets." The Service and Treasury anticipate that the rule will not require the capitalization of certain employee compensation, fixed overhead, and de minimis costs. Until the issuance of final guidance, "the Service will not assert capitalization under section 263(a) for employee compensation (other than bonuses and commissions that are paid with respect to the transaction), fixed overhead, or de minimis costs related to the acquisition, creation, or enhancement of intangible assets or benefits." Costs of $5,000 or less per transaction will be treated as de minimis.

This notice modifies our opinion of March 15, 1995 to the extent that the opinion provides for [redacted]'s capitalization of employee compensation (other than bonuses and commissions), fixed overhead, and de minimis costs (not more than $5,000 per transaction) incurred in the acquisition, creation, or enhancement of an intangible asset or benefit. Such intangible assets or benefits would include mortgages or other loans and interests in partnerships. Capitalization is still proper to the extent that salaries, fixed overhead, and de minimis costs are incurred in [redacted]'s acquisition of real property or the acquisition, creation, or enhancement of other tangible assets.

Generally, in your current examination of [redacted], you should not make any adjustments for the deduction of the costs covered by Notice 2002-21. On April 26, 2002, Larry Langdon (LMSB Commissioner) and Joseph Kehoe (SBSE Commissioner) issued a memorandum providing guidelines for the audit treatment of intangibles under § 263(a). Based on tax administration considerations, the commissioners determined that "examiners should not propose capitalization under section 263(a) for employee compensation (except for bonuses and commissions that are paid with respect to the transaction unless they fall under the de minimis threshold), fixed overhead, or de minimis transaction costs as defined in the Notice) related to the acquisition, creation or enhancement of intangible assets or benefits." The commissioners also state that section 446(e)'s adoption and change of accounting method rules continue to apply.

It would constitute an impermissible change in accounting method for a taxpayer, whose method of accounting had been capitalizing such costs, 1) to now attempt to currently deduct the past years' salaries on amended returns, 2) to deduct on its 2001 return the unamortized portion of the capitalized salaries from past years, or 3) to begin deducting in 2001 or 2002 the type of salaries it has been capitalizing. See I.R.C. §§ 446(e) and (f) and 481. Until it issues final guidance, the Service will not permit the taxpayer to change its accounting method to one that currently deducts the subject salary amounts.

Based on issued guidance to date we recommend making no adjustments with respect to the type of costs covered by Notice 2002-021 to the extent that [redacted]'s deducting the costs does not constitute a change in accounting method. Costs incurred in acquiring, creating, or enhancing tangible capital assets are not affected by Notice 2002-021, and such costs should continue to be capitalized.

In a prior audit cycle you made adjustments requiring [redacted] to capitalize certain salary costs relating to [redacted]'s [redacted], [redacted], and [redacted] activities. The taxpayer may not have a change in accounting method restriction if, as part of the prior examination, the Service or the taxpayer did not change the taxpayer's method of accounting (when the Service required the taxpayer to capitalize salaries incurred in the acquisition, creation, or enhancement of intangible capital assets). However, [redacted], (b)(5)(DP) [redacted]

You asked about the taxpayer now taking a current deduction for the unamortized portions of the salaries that were capitalized as part of the adjustments in a prior audit cycle. If the taxpayer's method of accounting provides for the current deduction of the salaries, Notice 2002-021 says that the Service will not litigate the taxpayer's deduction of the amount. Also the April 26, 2002 memorandum from Larry Langdon and Joseph Kehoe provides that the Service will not expend resources making examination adjustments to such deductions. In any event, the Service may have issued final guidance on this matter by the time the taxable year 2001 and 2002 income tax returns come under examination.

We are requesting the national office's 10 day post review of this opinion. It is possible that the national office may supplement, revise, or change the advice contained herein. Please do not act on this advice until the national office completes its 10 day review.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse affect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

If you have any questions on this matter, please call Michael Calabrese of this office at (414) 297-4241.

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By:____________________________
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